

## MEMORANDUM

**TO:** Kevin McDonald, Chief, CON, MHCC  
Maira Lawson, Analyst, CON, MHCC

**FROM:** Katie Wunderlich, Executive Director, HSCRC  
Jerry Schmith, Director, Revenue & Regulation Compliance, HSCRC  
Bob Gallion, Associate Director III, Revenue & Regulation Compliance, HSCRC

**DATE:** June 15, 2021

**RE:** Sheppard Pratt  
Sheppard Pratt at Elkridge Replacement Hospital  
Docket No. 15-13-2367

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This memo is in response to your request dated June 10, 2021 regarding the financial feasibility of the above referenced replacement hospital project. On September 20, 2016, the Maryland Health Care Commission (MHCC) awarded a Certificate of Need (CON) to relocate and replace the Ellicott City special hospital to Elkridge (Howard County). The original approved project cost was \$96,532,907 with four funding sources: \$66.7 million in debt, \$14.86 million in cash, \$7.5 million in philanthropic gifts, and \$7.5 million in state grant funding. On March 18, 2021, MHCC approved a \$9,099,505 increase (+9.4%) in the approved cost of the project, bringing the total cost estimate for the project to \$105,632,412. Sheppard Pratt stated that the additional funds required would be covered by an additional \$9 million in philanthropy. On June 8, 2021, Sheppard Pratt filed with the MHCC a Second Request for Post-Approval Project Change seeking to increase the project budget by \$7.4 million to account for previously understated capitalized interest for the new hospital construction, raising the total cost estimate to \$112,524,426. Additionally, there are significant changes to the funding of the project, with \$25 million of costs that were to be paid for by cash and philanthropy that will now be paid for by working capital loans. Other financing changes include a \$3 million increase in bonds, a \$2.5 million dollar increase in interest from bonds, and a \$2.5 million increase in state grant funding.

Specifically, you have requested that the staff of HSCRC review the financial projections provided in the CON modification application and subsequent filings, and then also advise MHCC of our opinion on the general financial feasibility of the proposed project. Additionally, you have requested that HSCRC staff comment on any other aspects of this CON modification application that may be pertinent. MHCC staff has commented that the utilization projections presented in the CON modification application are reasonable, and has asked HSCRC staff to assume that the utilization volumes projected by Sheppard Pratt will be achieved.

### **BACKGROUND**

As you have described it, the 85-bed special hospital would include 155,507 square feet (SF) of new construction on a 39-acre campus located at the intersection of Route 103 and Route 1 in Elkridge. The hospital will serve adolescents, young adults, the general adult population, adults with co-occurring conditions (i.e., adults with a primary psychiatric diagnosis and a secondary substance use disorder), and adults with psychotic disorders. The initial budget modification was due to increased costs for building materials and cost increases attributable to the COVID-19 pandemic. In addition, certain design changes

**Adam Kane, Esq**  
Chairman

**Joseph Antos, PhD**  
Vice-Chairman

**Victoria W. Bayless**

**Stacia Cohen, RN, MBA**

**John M. Colmers**

**James N. Elliott, MD**

**Sam Malhotra**

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**Katie Wunderlich**  
Executive Director

**Allan Pack**  
Director  
Population-Based Methodologies

**Tequila Terry**  
Director  
Payment Reform & Provider Alignment

**Gerard J. Schmith**  
Director  
Revenue & Regulation Compliance

**William Henderson**  
Director  
Medical Economics & Data Analytics

added to the cost of materials and the associated design adjustments, and the extension of the project timeline resulted in additional costs for architectural and engineering fees. The second request for budget modification was due to the applicant having underestimated the capitalized interest for the new hospital. The actual capitalized interest is \$9.7 million as compared to the original \$2.3 million budgeted. The increase is related to the timing of debt issuance and delays in construction related to the COVID-19 pandemic.

### **THE PROJECT**

As you have described it, the total cost of the project is currently estimated at \$112.5 million, sourced as follows: \$5.0 million from philanthropy, \$70.0 million from bonds, \$2.5 million from interest earned on bond proceeds, \$25.0 million from working capital loans, and \$10.0 million from state grants.

### **HSCRC REVIEW, DISCUSSION, and OPINION**

HSCRC staff has reviewed the Request for Post-Approval Project Change dated March 4, 2021 and the related Report for Modification dated March 18, 2021. Additionally, HSCRC staff has reviewed the Second Request for Post-Approval Project Change dated June 8, 2021 and the related applicant's response dated June 10, 2021 to Additional Information Questions dated June 9, 2021. In addition to reviewing the aforementioned materials, HSCRC staff worked with executive management of the applicant to further explore the financial projections utilized in ongoing discussions between HSCRC and the applicant for purposes of researching potential amendments to its Approved Revenue. These projections were built upon those that the applicant previously submitted to MHCC. Upon review of these materials, observations were noted and conclusions were reached as follows:

The Table E - Project Budget as currently configured reflects the history of the project uses of funds and the current understanding of available information on project sources of funds. The Table E presentation has evolved since it was initially shared with the HSCRC as a result of inquiries and explorations inherent in discussions surrounding the potential for amendments to its Approved Revenue. It is our current understanding that the current presentation of Table E will not materially change going forward. Uses of project funds total \$112,524,426 and are comprised of \$111,474,865 for capital and \$1,049,561 for financing. The material change from Table E as previously approved by MHCC was an addition of \$7,427,014 for gross interest during the construction period. This change was needed to account for the extended construction period due to the effects of the COVID-19 pandemic and the capitalized interest during that extended period, which flows to the computation of annual depreciation upon completion and commencement of operations. Not all construction related invoices have been received and paid; however no material overruns are anticipated.

Sources of project funds total \$112,524,426 and are comprised of \$5.0 million from philanthropy, \$70.0 million from the project specific portion of the MHHEFA bonds dated December 2017, \$2.5 million from interest earned on such bonds, \$25.0 million from the working capital portion of the MHHEFA bonds, and \$10.0 million from state grants appropriations. The total value of sources changed from that as previously approved by the MHCC by the same \$7.4 million increase in capitalized interest discussed above. Certain reclassifications of the components of those sources have been made so as to present Table E sources consistent with the current understanding of fund availability, not all of which was known with any degree of certainty at the time of the presentation, and was still in process to become realizable cash. The philanthropy was supported by donor documentation; the state grant was supported by appropriations; and the residual draw on the working capital portion of the MHHEFA bond essentially serves as the plug to balance out the sources. Both the philanthropy and the grant were nearly fully collected this month; at the time of this writing, just \$1.5 million is outstanding and is documented by the donor. The interest earned on the bond proceeds was discovered through the same discussions that yielded the capital interest. It is the opinion of the HSCRC staff that the classifications of the sources were dynamic until such time as they were confirmed; at present, virtually all is cash collected.

The Table H – P&L Inflated Entire Facility or Service (inclusive of regulated and unregulated operations) as used in discussions with HSCRC was built upon that previously referenced by MHCC, and was amended by the applicant to reflect forward looking operating challenges and cost pressures inclusive of payroll and professional liability insurance. The HSCRC staff has further amended the 5-year Table H projections to account for: a reasonable estimate of the annual growth in rates/prices for regulated services; a reasonable/conservative estimate for any Approved Revenue award that may result from discussions still in progress; a reasonable estimate of contra-revenues;

provisions for interest and depreciation related to debt incurred and assets acquired from the project; and the results of discussions with the applicant's executive management team related to all operating items reflected in the projections. The assumptions incorporated in the current status of Table H projections include: that the applicant shall achieve the volumes projected in the CON as advised by MHCC and upon which the projected revenues are based; a 2.57% increase in unit prices for FY 2022 based upon the most recently approved update factor analysis; a 2.89% increase in service rates going forward based upon review of the average of such increase over the most recent 5-year history of the rate file; a placeholder estimate of a \$1,080,000 increase to permanent Approved Revenue for FY 2022 based upon review of current methodology models for capital and operational provisions for all of regulated operations and the share of such revenues related to the Ellicott City/Elkridge project; an 18.6% contra-revenue assumption based upon a review of most recent 3-year-history; an estimate of \$25.99 million for FY 2022 payroll and benefits expense which ties to Table L and which is subjected to a 21% increase over 3 years in an attempt to get back to market rates of compensation and to reduce excessive employee turnover; an annual interest expense which ties back to an amortization of the 2017 MHHEFA bond inclusive of funding for project construction and working capital components; and annual depreciation of acquired assets based upon capitalized interest over the construction period and estimated useful lives by asset category. The P&L projections reflect a positive operating margin in four (4) of the five (5) years presented, and a cumulative operating margin of \$3.1 million over the 5-year projection (averaging 1.4% of operating revenues). The fifth and final year presented (FY 2026) reflects a \$357,723 positive margin (0.7% of operating revenues). Applicant's management believes that the bottom line margin is expected to grow as a positive measure beyond the period presented as no further cost escalations for payroll are anticipated. Please note that the projections are prepared under the accrual basis of accounting. The cash projected to be generated annually by the project is \$3.7 million more than the accrual based margin, due to depreciation not being a cash-based expense but rather an allocation of historical cost previously spent.

Staff has reviewed the two most recently published audited financial statements of the applicant and has reconciled the operating performance of the Ellicott City operation to the consolidating presentation. A review of the most recent internally prepared quarterly consolidating financial statements (March 31, 2021) reflects the Obligated Group, inclusive of Sheppard Pratt Health System, Inc., which in turn includes the present operations at Ellicott City, scheduled to move to the Elkridge location this month (June 2021). The balance sheet reflects cash balances of \$42.0 million, current assets of \$76.3 million, and total assets of \$600.7 million with net assets (equity) of \$339.6 million. The number of day's cash on hand to fund cash basis operating expenses calculates to 382 days, as compared to its debt covenant of 100 days. The ratio of debt to assets is 28%, and the ratio of debt to equity is 49%, both reflecting relatively healthy measures. The debt service coverage ratio is calculated at 2.61 as compared to the covenant of 1.1. The debt financing this Elkridge project is the 2017 MHHEFA bonds that are included in the above measures. Thus, in general terms, the balance sheet resources are not excessively burdened with debt, and the cash resources are more than sufficient to fund all present operations.

You have requested that HSCRC staff opine on the financial feasibility of the 85-bed psychiatric hospital project proposed by Sheppard Pratt. Based upon review of the history of audited financial statements, and the most recent internally prepared financial statements, staff is comfortable that the applicant has sufficient working capital to maintain the operation from its inception throughout at least five years after the completion and full occupancy of the project; that such use of its working capital does not put at risk the financial position of the applicant; and that the project can achieve a positive operating margin at least two to five years after project completion and full occupancy. We base the opinion on sufficient competent evidence as submitted by the applicant in the initial CON application and the ongoing discussions of the HSCRC with management. At this time, based upon review of all the submitted materials, staff is of the opinion that this project is financially feasible.